United States Court of Appeals

for the Second Circuit

PETITION FOR REHEARING EN BANC

74-2582

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B P/S

ROSALIND FOGEL and GERALD FOGEL,

Plaintiffs-Appellants,

-against-

GEORGE A. CHESTNUTT, JR., et al.,

Defendants-Appellees.

PETITION OF DEFENDANTS FOR REHEARING AND SUGGESTION FOR REHEARING IN BANC

Attorneys for Defendants-Appellees
(other then American Investors
Fund, Inc., nominal defendant)

Of Counsel:

Clendon H. Lee

ROGERS HOGE & HILLS
90 PARK AVENUE
NEW YORK, N.Y. 10016

(212) 953-9200

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Plaintiffs-Appellants,

-against-

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Docket No. 74-2582

PETITION OF DEFENDANTS FOR REHEARING AND SUGGESTION FOR REHEARING IN BANC

TO THE HONORABLE JUDGES OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

Petitioners Chestnutt Corporation, et al, pray that the judgement entered upon this Court's decision made December 30, 1975 be vacated; resprectfully suggest rehearing EN BANC upon supplemental briefs; and furth[illegible] pray that the Securities and Exchange Commission be invited to participate both on brief and upon oral argument.

It is respectfully submitted that the panel has overlooked or misapprehended the matters among others set forth below.

1. The decision herein is flatly inconsistent and conflicts with that of the Supreme Court in SEC v. Capital Gains Research Bureau, 375 U.S.180,190(1963) which praised

> "...not engaged in any activity such as security selling or brokerage, which might directly or indirectly bias an investment judgement...".

By contrast, the decision herein penalizes defendants retroactively for many years, for failing to accomplish compulsory vertical integration by acquisition and entering into a new business in square conflict of interest, all the while obedient in letter and in spirit to centuries of undivided loyalty in the precise terms commended by the Supreme Court in 1963 when the nominal defendant was $6 million in size.

We can agree with the quotation from Plaintiffs' attorney printed the day after the decision (Wall Street Journal, December 31, 1975, p.5)

> "Mr. Pomerantz predicted a 'chain reaction' of suits in New York against other advisers of mutual funds that haven't tried to recapture commissions."

Already, another appeal is pending in this Court ready for argument in Tannenbaum v. Zeller (CCH,¶95,257). The Amicus herein has completed a trial (Papilsky v. Berndt, 71Civ.2534) and the case is awaiting decision. Necessarily, a number of panels will become charged with decisions in a number of cases.

2. The decision fails to mention the dozen years or so in which the defendants were engaged in the investment counseling business since 1946 before American Investment Fund, Inc., (the Fund) commenced business. The adviser was a registered adviser under the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.) (See Def.br., p.3), as described in the Capital Gains Research Bureau case.

Defendants took the course praised by the Supreme Court of not engaging in "security selling or brokerage" and have steadfastly adhered to such course of action as an underlying assumption to this very day.

3. At no time has the SEC mandated activity contrary to the Supreme Court's declaration, nor prohibited activity consistent therewith, in connection with what this opinion properly refers to as the "root" of the problem. Now, under Gordon v. NYSE U.S. , 45L.Ed2d 463, the cartel has gone Scot-free whereas an admittedly "harsh" (op.,p.) and retroactive liability is visited as further injury upon persons powerless to affect the course of events.

4. This astonishing result of forced vertical integration - unprecedented in any field of law so far as we know - retroactive and "harsh", conflicts even with its putative antecedent. Moses v. Burgin (1 Cir.,1971)445 F2d.369,375 expressly held

> "...the directors had no duty to pursue plaintiff's suggested course of action, and without their doing so, recapture was not freely available. Plaintiff knew of Fund's practice when she bought her shares; she could have chosen a fund that did have an affiliated broker." (Emphasis added)

Here, the Court ignored wholly the track of investment counseling of a registered investment adviser and its pattern of nonconflicting activities since 1946. The Court took the wrong track of brokerage and underwriting, in which defendants have never engaged, and deduced liability for failure to enter a new business, inconsistent with the standard commended by the Supreme Court in SEC v. Capital Gains Research Bureau, supra, and now flatly prohibited by Congress in the Securities Acts Amendments of 1975.

5. Thus, if this Court commanded a prospective remedy consistent with its opinion - it would be illegal by Act of Congress.

To command a "harsh" retroactive remedy is wholly inconsistent with what the Supreme Court likewise said:

> "The report stressed that affiliations by investment advisers with investment bankers, or corporations might be "an impediment to a disinterested, objective, or critical attitude toward an investment by clients..." (at 187-188)

and further:

> "The report incorporated the Code of Ethics and Standards of Practice of one of the leading investment counsel associations, which contained the following canon:
>
> "[An investment adviser] should continuously occupy an impartial and disinterested position, as free as humanly possible from the subtle influence of prejudice, conscious or unconscious; he should scrupulously avoid any affiliation, or any act, which subjects his position to challenge in this respect." (at 188, emphasis the Court's)

No defendant ever received a red cent with which to pay any such liability, arising out of single minded obedience to non-conflicting interest.

For the Court to take the wrong track of brokerage and underwriting, rather than investment counseling, is attributable to informal aberrant language by the SEC, what this Court properly called "remarks", which encouraged conflicts of interest in fact - not merely in theory - with respect to joint profit centers created by certain "dealer distributed" funds - in huge complexes.

6. The opinion omits to note that there was no "compensation or payments" to any "recipient". There were no "compensation or payments received FROM such investment company, or the security holders thereof, BY such "recipient". (Section 36(b) Investment Company Act of 1974. Emphasis added)

The words of the governing statute were not referred to.

The burden of proof on plaintiff (revolutionizing fiduciary law) was not referred to.

Even on the face of the opinion there is no fact of damage (see Def.br.p.35-36)

Moreover, pursuant to Section 17(e) of that Act, during the period involved defendant could, were it to have entered a conflicting brokerage relationship, have received and pocketed full minimum commission rates.

The fact of damage was precluded, even as to a red cent.

7. The decision fails to adhere to the "clearly erroneous" standard of Rule 52(a),F.R.Civ.Pr., as construed in Stanton v. U.S., 363U.S.278, in that among other things:

a. The oral testimony of the directors was heard and weighed by the trial court (Def.br.pp.13-19)

b. Such weighing of oral testimony was necessary to the finding (383F.Supp at 919) below that

> "The use of reciprocals and giveups was fully disclosed in the prospectuses of the Fund",

since the directors discussed and signed registration amendments each year after being furnished copies before meetings.

c. The trial judge weighed the testimony of witness Wetherill who had to leave the witness stand to learn in 1973 what it is contended defendants should have known before.(Def.br.;p.24)

8. Subsequent to filing defendants' brief, the Supreme Court decided Gordon v. NYSE, U.S. , 45L.Ed2d463 and U.S. v. NASD, U.S. , 45LEd2d486. The decision herein conflicts with both.

In Gordon, the SEC's active concern for competition did not mandate competition until formal action by the SEC.

The SEC's thinking out loud for more than 10 years did not change its regulations having the force of law.

That portion of its thinking out loud directed to investment companies did not change the regulations or rules relating to mutual funds, any more than it did the regulations under §19 of the Securities Exchange Act of 1934.

Leviathan acts by thrashing its tail - not by vapor spouts. "Thar' she blows" is not an adequate ratio decidendi for determining offical action.

Collateral attack, both public and private, "...where [the SEC] has not deemed it appropriate to prohibit the conduct." has been precluded. U.S. v. NASD, note 41 and accompanying text including Court's statement "We agree."

In the NASD case we invite special attention to notes 3, 13, 21, 22 and 45, together with the accompanying text.

Here there is no showing of violation or failure to adhere to any rule or regulation of the SEC, or of any exchange, or of the NASD.

Here we have what this Court referred to as "remarks" in a voluminous report tending to encourage joint profit centers be-

tween advisers and mutual funds, in derogation of the Supreme Court's words, supra, in Capital Gains Research Bureau.*

The splitting of 40 or 50% (6 billion dollar I.D.S. being in a position of noblesse oblige) of prospective profits to arise from self-dealing, enhanced by leverage with respect to reciprocal nonfund business by its very terms applied only to "dealer-distributed" funds with functioning underwriters, having either capitve or outside salesmen.

The hortatory comments never had the force of law. Indeed, he who ran could hardly read it. He who paused to devine entrails (i.e. "dealer-distributed") would be confirmed in the belief it did not apply to a no-load fund and was "inoperative". He who acted upon it would embark upon a course of self dealing fraught with conflicts and temptations.

The separate issue of tender fees, concerning which there is nothing in the trial record whatever, must in any event be considered de novo, since we are advised that as late as mid-1972 the SEC refused "to be understood or construed to be an interpretation that [recapture of tender offer fees] would be in accord with applicable statutory or regulatory provisions" and it was not until a year later - mid 1973 - that a ruling was made.

Defendants brief (p.26) shows the $2,945 and $6,990 "net" savings from regional exchange dealings of two huge conglomerates with no-load funds. We understand that these several

*For a description of an earli[illegible] disregard of a Judge, see Book of Judges, Chapter 2, Verse [illegible]

billion dollar entities are the only no-load complexes to have recently so experimented.

One good, impartial investment decision on one day could benefit the 20 to 40 million Fund shares outstanding more than years of diverted efforts in conflicting interests.

This Court has substituted the hypothetical testimony of two witnesses for that of the directors.

As to NASD and PBW, it is as if a golf professional's alimony were to be increased upon third party testimony he was eligible to enter a tournament in which he did not compete.

This Court's equating the adviser with a broker we believe conflicts with every definition known to the law and the exchanges and NASD. See e.g. notes 3, 21, and 22 in the NASD case, supra.

Only a full supplemental brief can deal adequately with these matters.

Prospective action by statute, regulation or rule, rather than retroactive remedy, are the teaching of both the Gordon and NASD cases, and are cut from the same cloth as Helvering v. Griffiths, 318U.S.371 where the Court stated at 402:

> "We are asked to make a retroactive holding that for some seven years past a multitude of transactions have been taxable although there was no source of law from which the most cautious taxpaper could have learned of the liability. If he consulted the decisions of this Court, he learned that no such tax could be imposed; if he read the Delphic language of the Act in connection with existing decisions, it, too, assured him there was no intent to tax; if he followed the congressional proceedings and debates, his understanding of nontaxability would be confirmed; if he asked the tax

collector himself, he was bound by the Regulations of the Treasury to advise that no such liability existed. It would be a pity if taxpapers could not rely on this concurrent assurance from all three branches of the Government. But we are asked to brush all this aside and simply to decree that these transactions are taxable anyway."

CONCLUSION

The panel's decision should be reconsidered in banc upon supplemental briefs; the SEC should be invited to participate. The judgement of the Court below should be affirmed and the complaint dismissed.

Respectfully submitted,

ROGERS HOGE AND HILLS

By Clendon H. Lee
Attorneys for Defendants-Appelles (other than American Investors Fund, Inc., nominal defendant)

90 Park Avenue
New York, New York 10016
Tel. No. 953-9200

Of Counsel:

Clendon H. Lee

AFFIDAVIT OF SERVICE
BY MAIL

STATE OF NEW YORK)
) SS:
COUNTY OF NEW YORK)

I, Athena Cokkinos, being duly sworn, depose and say that I am over 18 years of age, am not a party to the action and reside at 31-76 46th Street, Long Island City, New York. That on the 13th day of January, 1976 I served the within Petition of Defendants for Rehearing and Suggestion for Rehearing In Banc (two copies) upon

Pomerantz Levy Haudek & Block, Esqs.
295 Madison Avenue
New York, N.Y. 10017

Dewey, Ballantine, Bushby, Palmer & Wood
140 Broadway
New York, N.Y. 10005

Rogers & Wells
200 Park Avenue
New York, N.Y. 10017

attorneys for respective parties, at the addresses designated by said attorneys for that purpose by depositing a true copy of same enclosed in a postpaid properly addressed wrapper, in a post office or official depository under the exclusive care and custody of the United States Post Office Department within the State of New York.

Sworn to before me this 13th day
of January, 1976

Athena Cokkinos

Eve T. Girimonti
Notary Public.

EVE T. GIRIMONTI
Notary Public, State of New York
No. 41-4503555
rtificates filed in New York County
and Queens County
ommission Expires March 30, 1977